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AIG's Financial Distress: How Credit Default Swaps and the Lack of Regulation Brought Down an Insurance Giant and Implications for the Insurance Industry

by
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I. INTRODUCTION

The recent financial collapse of American International Group, Inc. ("AIG") came as a shock to many people. How, they wondered, could one of the largest insurance organizations in the world fall so far and so quickly, to the point of bankruptcy and eventual bailout by the federal government? Equally troubling are the implications of AIG's collapse on the insurance industry, in terms of the possible future of AIG's subsidiary insurance companies and the potential for changes in the way insurance is regulated going forward.

This article will attempt to address these questions and concerns. First, it will provide a brief summary of the causes of AIG's financial distress, including a discussion of credit default swaps, the arcane financial instruments at the root of the collapse, how they caused AIG's downfall, and what the federal government has done to rescue (or at least to ease the transition of) AIG. Next, this article will discuss some of the implications for the insurance industry. It will describe the relationship among AIG and its insurance subsidiaries and explain how that relationship, along with AIG's announced plan for paying back the $150 billion federal loan (plus interest), may affect the ability of the insurance subsidiaries to operate in the future. Unfortunately, so much remains uncertain about AIG's future that it is impossible to predict what, if anything, will happen to the insurance companies. The article also will explore the effect on the broader insurance industry, including the real possibility of comprehensive federal regulation of insurance for the first time in the history of the United States. Credit default swaps raise interesting issues concerning the nature of insurance and whether it makes sense to regulate them and similar financial instruments as insurance products. The article concludes that some form of increased federal scrutiny of insurance and credit default swaps is quite likely.

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II. THE CAUSES OF AIG'S FINANCIAL DISTRESS

A. A Summary of AIG's Corporate History and Structure

American International Group, Inc. is a holding company that owns or controls hundreds of subsidiaries.[1] AIG, through its subsidiaries, provides insurance and financial services in the United States and internationally.[2] Its insurance operations conduct business in four segments: General Insurance, Life Insurance and Retirement Services, Financial Services, and Asset Management.[3]

In the United States and abroad, AIG's General Insurance companies underwrite various business insurance products, including large commercial or industrial property insurance, excess liability, inland marine, environmental, workers' compensation, and excess and umbrella coverages.[4] This segment also offers various specialized forms of insurance, such as aviation, accident and health, equipment breakdown, directors' and officers' liability, difference-in-conditions, kidnap-ransom, export credit and political risk, and professional errors and omissions coverages.[5] In addition, it provides property and casualty reinsurance products to insurers; automobile insurance products; residential mortgage guaranty insurance products; and second-lien and private student loan guaranty insurance products.[6]

Domestic General Insurance operations are comprised of the Domestic Brokerage Group, Reinsurance, Personal Lines, and Mortgage Guaranty.[7] Domestic Brokerage Group, which provides commercial insurance products and services to a wide range of businesses in the United States, is the largest property-casualty insurance organization in the United States.[8] AIG's domestic insurance operations are conducted by approximately 55 different companies. These operations are 75% commercial insurance, 15% personal lines insurance, and 10% combined commercial and personal or reinsurance risks.[9] AIG's Foreign General Insurance group accepts risks primarily underwritten through American International Underwriters and AIG's foreign-based insurance subsidiaries.[10]

The Life Insurance and Retirement Services segment offers individual and

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[1] *See* American International Group, Inc., Annual Report (Form 10-K) 3 (Feb. 28, 2008) [hereinafter AIG Annual Report]. As of December 31, 2007, AIG owned or controlled 245 subsidiaries. *Id.* at 215–19.

[2] *Id.*

[3] *Id.*

[4] *Id.* at 6.

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *See* A.M. Best Company, Inc., Best's Company Report on National Union Fire Insurance Company of Pittsburgh, PA., July 17, 2008, at 3 [hereinafter A.M. Best Report on AIG].

[9] *Id.*

[10] AIG Annual Report, note 1 above, at 6.

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group life, payout annuities, endowment, and accident and health policies, as well as retirement savings products consisting of fixed and variable annuities.[11] This segment includes both domestic and foreign life insurance companies.[12]

The Financial Services segment provides aircraft and equipment leasing, capital market transactions, consumer finance, and insurance premium financing.[13] International Lease Finance Corporation is AIG's aircraft leasing business.[14] AIG Financial Products Corporation engages in transactions, as principal, to provide risk management solutions and hedging and investment products in standard and customized transactions involving commodities, credit, currencies, energy, equities and rates.[15] AIG's consumer finance business consists of American General Finance, Inc. and AIG Consumer Finance Group, Inc. AIG has one of the largest consumer finance organizations in the U.S., with a branch network in 45 states, Puerto Rico and the U.S. Virgin Islands.[16]

The Asset Management segment operations comprise investment-related services and investment products, including institutional and retail asset management, broker-dealer services, and spread-based investment products.[17] AIG Investments manages equities, fixed income, private equity, hedge funds, and real estate investments for institutional, individual and high-net-worth investors around the world.[18] AIG Private Bank Ltd., a Zurich-based private banking subsidiary, provides personalized private banking and structured wealth management solutions, including investment advisory and asset management products to a worldwide clientele.[19] AIG SunAmerica Asset Management Corp. manages and/or administers retail mutual funds, as well as the underlying assets in AIG SunAmerica and AIG Retirement variable annuities sold to individuals and institutional groups throughout the U.S.[20]

B. Playing with Fire: AIG's Involvement in Credit Default Swaps Leads to Financial Collapse

1. The Ignition Source: What Is a Credit Default Swap?

Headquartered in London, AIG Financial Products was the company responsible for selling credit default swaps.[21] Prior to the upheaval in the financial

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[11] *Id.* at 10.

[12] *Id.*

[13] *Id.* at 11.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.* at 11–12.

[18] *Id.* at 12.

[19] *Id.*

[20] *Id.*

[21] *See* Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. Times,

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industry and credit markets, few people outside of these areas had heard of credit default swaps. Such unfamiliarity on the one hand seems odd, given that the market for these instruments was so large. In 2000, the CDS market was around $631 billion.[22] By the end of 2007, it was valued at approximately $62 trillion.[23] The current value of the market is approximately $54 trillion, well over twice the size of the entire United States stock market, and much greater than the $7.1 trillion mortgage market and $4.4 trillion U.S. treasuries market.[24] On the other hand, ignorance of credit default swaps is understandable due to the fact that they have been entirely unregulated. The 2000 Commodity Futures Modernization Act includes provisions that expressly exempt "credit risks or measures" and "swaps" from federal regulation.[25] There are no regulations at the state level for credit default swaps either. As a result, the credit default market has operated without any oversight from any objective entity, subject only to the "self-regulation" of the market itself.[26] The consequences of this deregulated environment are now plainly seen.

At their heart, credit default swaps are rather easily described. Credit default swaps were invented in the mid-1990s by banks as a way to offset risk in their lending portfolios.[27] For example, if a party owned some of a corporation's bonds and it was concerned that the corporation might default on its debts, the party

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Sept. 28, 2008 (available at http://nytimes.com/2008/09/28/business/28melt.html) [hereinafter Morgenson, *Behind Insurer's Crisis*].

[22] *See* James B. Kelleher, *Buffett's "Time Bomb" Goes Off on Wall Street*, Reuters, Sept. 18, 2008 (available at http://www.reuters.com/articleId=USN1837154020080918). Warren Buffett has been a long-time critic of credit default swaps, calling them a "time bomb" and "financial weapons of mass destruction." *Id.*

[23] *See* Nicholas Varchaver & Katie Benner, *The $55 Trillion Question*, Fortune Magazine, Sept. 30, 2008 (available at http://money.cnn.com/2008/09/30/magazines/fortune/varchaver_derivatives_short.fortune/index.htm? postversion =2008093012); Associated Press, *Credit-Default Swap Data Ease Only Some Worries*, Nov. 7, 2008 (accessed at http://fpn.advisen.com/articles/article85009063-707276916.html).

[24] Varchaver & Benner, note 23 above; Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, Time, Mar. 17, 2008 (available at http://www.time.com/time/business/article/0,8599,1723152,00.html).

[25] *See* Pub. L. 106-554, § 407, 114 Stat. 2763 (2000); 7 U.S.C. §§ 1a(13), 2(d), 2(g) (2000).

[26] *See* Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 Fordham J. Corp. & Fin. L. 167, 171–72 (2007); Varchaver & Benner, note 23 above. The International Swaps and Derivative Association, Inc. ("ISDA") is the private organization of entities that trade in swaps and derivatives. *See* ISDA, *About ISDA* (available at http://www.isda.org/). The ISDA's mission is "to encourage the prudent and efficient development of the privately negotiated derivatives business," in part by "[p]romoting practices conducive to the efficient conduct of the business, including the development and maintenance of derivatives documentation." ISDA, *ISDA Mission* (available at http://www.isda.org/).

[27] Morrissey, note 24 above; Gretchen Morgenson, *Arcane Market Is Next to Face Big Credit Test*, N.Y. Times, Feb. 17, 2008 (available at http://www.nytimes.com/2008/02/17/business/17swap.html) [hereinafter Morgenson, *Arcane Market*].

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could purchase a credit default swap to hedge against this occurrence.[28] Commercial banks are still some of the largest participants in credit default swaps. In 2007, the top 25 banks were involved in buying and selling approximately $14 trillion worth of credit default swaps in the market.[29]

A credit default swap is a contract, in which one party pays a "premium" over a set time period to the other party in exchange for the other party's promise that it will pay the buyer in the event that a credit event, like a default on a loan or a credit rating downgrade, occurs.[30] This may sound very much like insurance, because that is what credit default swaps are, in substance.[31] As will be discussed in greater detail below, credit default swaps exhibit many of the core characteristics of insurance, including most significantly the transfer of fortuitous risk that is distributed across many buyers and sellers. Indeed, credit default swaps have been classified as a species of "credit default insurance."[32]

The only real difference between credit default swaps and what is commonly thought of as insurance is that swaps can be sold by the buyer and the seller to other entities, who in turn can sell them again, and so on down the line.[33] This feature allowed entities other than commercial banks to get involved in the market. Hedge funds and other speculators bought and sold heavily, betting that companies would fail and be unable to make their credit obligations, thus triggering payments on the swaps.[34] Credit default swaps were seen as a better, more secure option than selling stocks and bonds short, the traditional means of making money off of a company's declining fortunes in the relevant markets.[35] Banks were happy to sell credit default swaps during the booming economy of the

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[28] *See* Wayne Pinsent, *Credit Default Swaps: An Introduction* (available at http://investopedia.com/articles/option investor/08/cds.asp); Antulio N. Bomfim, Understanding Credit Derivatives and Related Instruments 68–69 (2005); Janet M. Tavakoli, Credit Derivatives 66 (1998).

[29] Morgenson, *Arcane Market*, note 27 above.

[30] Bomfim, note 28 above, at 68; Tavakoli, note 28 above, at 66; Blythe Masters & Kelly Bryson, *Credit Derivatives and Loan Portfolio Management*, *in* The Handbook of Credit Derivatives 48 (Jack Clark Francis, et al., eds. 1999).

[31] *See, e.g.*, Bomfim, note 28 above, at 68 (noting that "a credit default swap shares many similarities with traditional insurance products"); Pinsent, note 28 above (a credit default swap is "similar to insurance because it provides the buyer . . . with protection against . . . [a] negative 'credit event'" and the seller "assumes the credit risk"); Robert S. Neal & Douglas S. Rolph, *An Introduction to Credit Derivatives*, *in* The Handbook of Credit Derivatives, note 30 above, at 10 ("credit derivatives are financial contracts that provide insurance against credit-related losses").

[32] *See* Investopedia, *Credit Default Insurance* (defining "credit default insurance" as the "use of a financial agreement — usually a credit derivative such as a credit default swap . . . to mitigate the risk of loss from default by a borrower or bond issuer") (available at http://investopedia.com/terms/c/credit_default_insurance.asp).

[33] Pinsent, note 28 above; Morrissey, note 24 above; Morgenson, *Arcane Market*, note 27 above.

[34] Kelleher, note 22 above; Morrissey, note 24 above.

[35] Morgenson, *Arcane Market*, note 27 above.

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1990s because corporate defaults were few and swaps were an easy way to collect extra cash in the form of premiums.[36]

Because the market is unregulated, it was extremely difficult to track the movement of swaps as they were traded continuously. This not only made it hard to determine which entity was responsible for paying on a swap in the event of a credit event, it also undermined the viability of the swaps as they could, and did, end up in the hands of entities that were less financially stable than the original seller and had less ability to cover the payment obligations.[37] Moreover, unlike the insurance industry, there are no regulations governing how much surplus an entity must have to cover its obligations under the swaps.[38] There is no regulatory oversight to verify that the participants in the transactions can meet their obligations. With the market operating in secret, there is no reliable way to determine the true value of credit default swaps.[39] As it turned out, the valuation of the contracts was highly subjective, just as it was for mortgage-backed securities and other collateralized debt obligations that were insured by credit default swaps.[40]

Commercial and investment banks and other companies have had to take huge write downs based on the recognition of their potential losses from mortgage-backed securities.[41] Those losses may not in fact be covered by credit default swaps, which also turned out to be tremendously overvalued. For example, a recent auction involving $400 billion of Lehman Brothers' credit default swaps resulted in settlements of 8.625 cents on the dollar, meaning banks and other investors who had agreed to make payments in the event of Lehman's default will have to pay out 91.375 cents on the dollar.[42]

2. How Credit Default Swaps Burned AIG

AIG Financial Products, based in London, began selling credit default swaps in 1998.[43] In 2004, AIG started selling credit default swaps for collateralized debt

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[36] Morrissey, note 24 above.

[37] *Id.*

[38] *Id.*

[39] Morgenson, *Arcane Market*, note 27 above.

[40] *Id.*

[41] *See* Bloomberg News, *JP Morgan plans to write down $1.5 billion in mortgage-backed assets*, International Herald Tribune, Aug. 12, 2008 (available at http://www.iht.com/articles/2008/08/12/business/12jpm.php); David Jolly, *New $2.8 Billion Write-Down Jolts Credit Suisse*, N.Y. Times, Feb. 20, 2008 (available at http://www. nytimes.com/2008/02/20/business/worldbusiness/20bank.html); Aaron Kirchfeld, *Deutsche Bank to Write Down EU2.5 Billion in Quarter*, Apr. 1, 2008 (available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aDMJxmhhc3Ug&refer=home).

[42] *See* Shannon D. Harrington and Neil Unmack, *Lehman Credit-Swap Auction Sets Payout of 91.38 Cents*, Oct. 10, 2008 (available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aX_FLjiKfbic&dbk).

[43] *See* Carrick Mollenkamp, et al., *Behind AIG's Fall, Risk Models Failed Test*, The Wall Street

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obligations, including mortgage-backed securities.[44] By 2007, credit default swaps written by AIG covered more than $440 billion in various debt securities backed by corporate loans, automobile loans, credit card receivables and, most crucially, subprime mortgages.[45] AIG used computer models to predict the risk that the debt securities would default, and thus believed that they had adequately assessed the exposure from the swaps.[46] However, the buyers of swaps typically have the right to demand collateral if the debt securities decline in value, or if the seller's own debt rating is cut.[47] The seller also must account for the swaps on its books, and if their market value falls, the seller must reflect the loss.[48] AIG's computer models did not account for these last two financial risks from credit default swaps.[49]

In 2007, with housing prices continuing to fall, the subprime mortgage market faltering, and mortgage bonds losing their value, credit rating agencies lowered their ratings of mortgage securities.[50] The buyers of AIG's credit default swaps, including such companies as Goldman Sachs, began demanding billions of dollars of collateral from AIG as the perceived value of the underlying securities continued to decline.[51] In addition, AIG was forced to write down billions more on its books, not only because of the declining value of the securities but also because those securities were now at an increased risk of default.[52]

Throughout 2008, AIG needed to borrow tens of billions of dollars to meet the continuing collateral demands, but as the credit market worsened in August and September it became more and more difficult for AIG to obtain the needed cash.[53] On September 15, 2008, Lehman Brothers filed for bankruptcy and the credit markets ground to a halt.[54] The rating agencies downgraded AIG's credit rating the same day, triggering an immediate need for $14.5 to $18 billion to cover renewed demands for collateral.[55] AIG found itself in a fatal liquidity crisis, unable to raise this amount of money before it defaulted on its obligations.

Journal, Nov. 3, 2008 at 1; Gretchen Morgenson, *Behind Insurer's Crisis*, note 21 above; Adam Davidson, *The Big Money: How AIG Fell Apart*, Reuters, Sept. 19, 2008 (available at http://www.reuters.com/article/reutersEdge/idUSMAR8597272008 0919).

[44] Mollenkamp, note 43 above, at 1.

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *See* Nanette Byrnes, *Where AIG Went Wrong*, Business Week, Sept. 18, 2008 (available at http://www. businessweek.com/magazine/content/08_39/b4101040078511.htm).

[54] Mollenkamp, note 43 above, at 1.

[55] Byrnes, note 53 above; Mollenkamp, note 43 above, at 1.

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3. The Federal Government Attempts to Put Out the Fire

In exchange for a 79.9% stake in AIG, the Federal Reserve Bank of New York agreed to provide an $85 billion liquidity facility for AIG.[56] The facility was designed to provide an opportunity for the orderly sale of AIG's assets, hopefully with minimal disruption to the overall economy. Any amounts borrowed from the liquidity facility were to be repaid within two years.[57] It was widely speculated that this assistance alone might not be sufficient to enable AIG to survive and prosper long-term.[58] The financial terms of the liquidity facility are onerous, with a high interest rate, and the funds are available only for a limited time (24 months).[59] The loan is collateralized by all of the assets of AIG and its primary non-regulated subsidiaries, as well as the stock of "substantially all" of the insurance companies.[60]

On October 3, 2008, AIG announced its intent to refocus the company on its core property and casualty insurance businesses.[61] AIG stated its intention to retain its U.S. property and casualty and foreign general insurance businesses.[62] AIG also explained its desire to maintain an ownership in its foreign life insurance operations.[63] AIG has stated that its worldwide property and casualty businesses generated approximately $40 billion in revenues in 2007.[64]

The demands for collateral on credit default swaps did not cease, and by September 30, 2008, AIG had already drawn $61 billion from the federal credit facility to meet these demands.[65] At that point, it became clear that AIG would require far more than the original $85 billion. On October 8, 2008, the Federal

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[56] *See* Board of Governors of the Federal Reserve System, Press Release, Sept. 16, 2008 (available at http://www. federalreserve.gov/newsevents/press/other/20080916a.htm); Edmund L. Andrews, et al., *Fed's $85 Billion Loan Rescues Insurer*, N.Y. Times, Sept. 16, 2008, at A1 (available at http://www.nytimes.com/2008/09/17/business/17 insure.html?pagewanted=2); AIG Commercial Insurance Press Release, Sept. 19, 2008 (available at http://www. aig.com/_20_120269.html (follow September 19, 2008 "AIG Commercial Insurance Fact Sheet" hyperlink).

[57] Andrews, note 56 above, at A1.

[58] *See* Hugh Son, *AIG Sales May not Repay U.S. Loan, Forcing New Deal*, Bloomberg, Nov. 6, 2008 (available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=azDWhftUUml4); Carol D. Leonnig, *Effectiveness of AIG's $143 Billion Rescue Questioned*, Washington Post, Nov. 3, 2008, at A18 (available at http://www. washingtonpost.com/wp-dyn/content/article/2008/11/02/AR2008110202150.html).

[59] Board of Governors of the Federal Reserve System, note 56 above.

[60] *Id.*

[61] *See* AIG, *AIG to Refocus as Worldwide Property and Casualty Company with Continuing Presence in Foreign Life*, Oct. 3, 2008 (available at http://www.aigwebcast.com/phoenix.zhtml?c=76115&p=irolnewsArticle&ID= 1205337&highlight=).

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *See* Mary Williams Walsh, *Fed Adds $21 Billion to Loans for A.I.G.*, N.Y. Times, Oct. 31, 2008 (available at http://www.nytimes.com/2008/10/31/business/31aig.html).

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Reserve Bank of New York said it would lend AIG another $37.8 billion.[66] In exchange, AIG said it would give investment grade, fixed-income securities as collateral.[67] In total, as of October 8, 2008, the government had made approximately $123 billion available to AIG. The $37.8 billion of fixed-income securities came from AIG's regulated life insurance subsidiaries.[68]

By October 16, 2008, AIG had borrowed a total of $82.9 billion.[69] In just a week, AIG's borrowing increased to $90.3 billion of the approximately $123 billion available.[70] On October 30, 2008, AIG reported that it had been given access to the Federal Reserve Bank's new commercial paper program, which would allow AIG to reduce its reliance on the costlier emergency loan from the Bank.[71] Under the new program, AIG would be able to borrow up to $20.9 billion, raising its maximum available credit from the Fed to $144 billion under three different programs.[72] This new assistance package enables AIG to reduce the original $85 billion loan to about $60 billion, lowers the interest rate and gives AIG five years, instead of two, to pay it off.[73]

On November 10, 2008, the government raised its total support for AIG to $150 billion.[74] The Treasury Department will use money from its Troubled Asset Relief Program to purchase $40 billion in senior preferred stock from AIG as part of a comprehensive plan to restructure federal assistance to AIG.[75] AIG will reportedly use the equity to pay down $40 billion of the Federal Reserve's secured lending facility.[76]

On the same date, AIG reported its third quarter 2008 results. AIG reported a

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[66] *See* Board of Governors of the Federal Reserve System, Press Release, Oct. 8, 2008 (available at http://www. federalreserve.gov/newsevents/press/other/20081008a.htm).

[67] *Id.*

[68] *See* Barry Meier and Marry Williams Walsh, *A.I.G. to Get Additional $37.8 Billion*, N.Y. Times, Oct. 9, 2008, at B1 (available at http://www.nytimes.com/2008/10/09/business/economy/09insure.html?scp=1&sq=AIG%20%22life %20insurance%20subsidiaries%22&st=cse); Arthur D. Postal, *AIG Might Need More Gov't Support in Tight Credit Market*, National Underwriter 7, Nov. 3, 2008.

[69] *See* Ben Rooney, *AIG Cuts Perks, Borrows $12B*, Oct. 16, 2008 (available at http://money.cnn.com/2008/10/16/ news/economy/AIG_loan/index.htm).

[70] Postal, note 68 above, at 7.

[71] Mary Williams Walsh, note 65 above.

[72] *Id.*

[73] *Id.*

[74] *See* Board of Governors of the Federal Reserve System, Press Release, Nov. 10, 2008 (available at http://www. federalreserve.gov/newsevents/press/other/20081110a.htm); Daniel Hays and Mark E. Ruquet, *AIG Renegotiates Terms of Federal Loan to Buy More Time, Lower Interest Rates*, National Underwriter 6, Nov. 17, 2008.

[75] Board of Governors of the Federal Reserve System, note 74 above; Hays & Ruquet, note 74 above, at 6–7.

[76] Board of Governors of the Federal Reserve System, note 74 above; Hays & Ruquet, note 74 above, at 7.

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net loss of $24.47 billion or $9.05 per diluted share compared to 2007 third quarter net income of $3.09 billion or $1.19 per diluted share.[77] Third quarter adjusted net loss was $9.24 billion or $3.42 per diluted share, compared to adjusted net income of $3.49 billion or $1.35 per diluted share for the third quarter of 2007.[78]

III. IMPLICATIONS OF AIG'S FINANCIAL DISTRESS ON THE INSURANCE INDUSTRY

The deterioration in AIG's financial situation raises several issues related to insurance. One set of issues concerns the possible future of AIG's subsidiary insurance companies, and other issues are more broadly focused on potential changes in the insurance industry. Many risk managers and lawyers began confronting the first set of issues almost immediately after news of AIG's brush with bankruptcy and subsequent government bailout became public: are the insurance subsidiaries at risk of bankruptcy or liquidation themselves, and what would happen to them, the insurance policies they issued, and their ability to pay claims if they are unable to operate? The other issues have to do with concerns over the adequacy of the scope and rigor of the current schemes to regulate insurance companies. For example, the possibility of federal regulation of insurance companies is under serious discussion within the industry and the government. One question that deserves closer scrutiny is whether credit default swaps and similar financial instruments should be regulated as insurance products. This could place substantial restrictions on how these products are traded, which, given the current financial debacle arising in no small part from unrestricted buying and selling of credit default swaps, could be a desirable result.

A. The Potential Negative Impact of AIG's Collapse on Its Insurance Company Subsidiaries

It is not unreasonable to ponder the fate of AIG's insurance subsidiaries when their parent holding company teeters on the brink of bankruptcy and has to be bailed out by an initial $85 billion loan (now increased to $150 billion in aid) from the federal government. However, whether the insurance companies are at risk of failure, even after the parent company has been at least temporarily stabilized by the infusion of billions of dollars, depends on many factors, the interplay of which cannot be predicted with any high degree of certainty. Indeed, the only thing that is certain at this point is that any predictions of the future of AIG and its insurance companies are likely to be wrong. Thus, this article will not attempt such predictions, but rather will look at some of the factors that could influence the outcome.

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[77] *See* AIG, *Consolidated Premiums and Other Considerations Totaled $21 Billion, up 7 Percent*, Nov. 10, 2008 (available at http://phx.corporate-ir.net/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1224194&highlight=); Hays & Ruquet, note 74 above, at 40.

[78] AIG, note 77 above; Hays & Ruquet, note 74 above, at 40.

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1. The Relationship Between AIG's Financial Performance and That of Its Insurance Company Subsidiaries

The first factor is the relationship between AIG and its insurance subsidiaries. As was discussed above, AIG is a holding company with many subsidiaries, mostly insurance companies. It was the non-insurance Financial Services operating segment of AIG's companies that was responsible for AIG's financial problems, primarily the selling of credit default swaps. The property and casualty insurance subsidiaries are separate companies, each with its own corporate identity, structure, lines of business and resources. These companies as a whole are well capitalized, with over $26 billion in surplus.[79] The state regulations applicable to these companies (*i.e.*, the regulations of the states where the companies are domiciled, including New York, Pennsylvania, Illinois and Delaware) require the insurers to maintain sufficient reserves to pay claims.[80] AIG and the regulators have been adamant that the insurers' surpluses will not be made available to prop up the parent company or pay down the federal loan.[81] Looked at as stand-alone entities, the property and casualty subsidiaries are stable, solvent companies.

That is the good news. The potential bad news is that historically the insurance companies have not been viewed as stand-alone entities. Instead, the stability of the insurance subsidiaries has been rated, at least in part, based on the performance of the parent company. A.M. Best Company, Inc. is the agency viewed as primarily responsible for rating the credit-worthiness and financial

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[79] *See* Rob Schimek, *AIG and AIG Commercial Insurance: Overview and Financial Update*, Nov. 13, 2008, at 6, 9, http://www.aig.com/_20_120269.html (follow "Overview and Financial Update" hyperlink).

[80] *Id.* at 9.

[81] *Id.*; New York State Insurance Department, *AIG Policyholders Should Be Careful if Approached to Replace Policies*, Sept. 22, 2008 (available at http://www.ins.state.ny.us/press/2008/p0809222.htm); Insurance Department Commonwealth of Pennsylvania, *Insurance Department Assures AIG Policyholders*, Sept. 24, 2008 (available at http://www.ins.state.pa.us/ins/cwp/view.asp?A=11&Q=549447). Such assurances may need to be taken with a large grain of salt. In the first few days following the announcement of AIG's imminent collapse, New York Governor David Paterson and New York Insurance Superintendant Eric Dinallo announced a plan to have the insurance company subsidiaries transfer $20 billion in liquid assets to the parent company in exchange for illiquid assets (*i.e.*, bad mortgage-backed securities), to give the parent immediate access to cash to ease its liquidity crisis. *See* David S. Hilzenrath and Zachary A. Goldfarb, *N.Y. Will Let AIG Borrow $20 Billion from Its Own Subsidiaries*, Washington Post, Sept. 15, 2008 (available at http://www.washingtonpost.com/wp-dyn/content/article/2008/09/15/AR2008091501213.html). This plan was not implemented because of the federal government's intervention.

Later, the federal government did allow AIG to use investment grade, fixed-income securities from its life insurance subsidiaries as collateral for a loan. *See* Board of Governors of the Federal Reserve System, note 66 above; Meier & Walsh, note 68 above, at B1. The willingness of government officials to take assets away from the insurance companies and weaken their financial position, is troubling, to say the least, and arguably not in the best interests of the insurers or their policyholders.

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performance of insurance companies.[82] A.M. Best observes generally that "[t]he implicit or explicit support of a parent or affiliate can affect an insurer's financial strength and therefore its Best's Rating."[83] A.M. Best has relied on the AIG parent's financial health and ability to contribute capital to its insurance company subsidiaries when issuing an A+ rating for the AIG insurance subsidiaries:

> The AIG Commercial Lines Pool has historically benefitted from its recognition as a core operation with American International Group, Inc., *which maintains extensive global financial flexibility*. More importantly, *the consolidated enterprise has the willingness and ability to provide capital to domestic insurance operations* which was evident in 2005 with $4.5 billion of cash infusions and letters of credit. The tangible support in the form of a capital infusion was necessary as a result of a decline in capital resulting from the 2004 statutory accounting restatements, catastrophe losses in 2004 and 2005 and significant prior year reserve development recognized each year from 2002 through 2005.[84]

Furthermore, A.M. Best noted:

> Barring extraordinary events such as an abnormal level of catastrophe losses, A.M. Best expects AIG's overall capitalization in 2008 to remain supportive of its current rating although significant increases are not expected given the level of shareholder dividends expected to be upstreamed as a result of increased holding company cash needs.[85]

The parent company's ability to provide additional capital to an insurance subsidiary is a significant element in the stability of that subsidiary. In 2005, for example, AIG infused $3.7 billion into insurance subsidiaries in need of additional capital, primarily in AIG's Commerical Insurance Group.[86] The capital can flow the other way as well. Over the last five years, AIG's domestic insurance operations upstreamed $5.3 billion in dividends to parent companies.[87]

On September 15, 2008, as AIG was undergoing its financial collapse, A.M. Best downgraded the ratings of AIG's insurance subsidiaries from "A+" to "A."[88]

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[82] *See* Riley v. Murdock, 890 F. Supp. 444, 458 (E.D.N.C. 1995), *aff'd*, 83 F.3d 415 (4th Cir. 1996) (describing A.M. Best as "the preeminent authority rating insurance companies").

[83] A.M. Best Company, Inc., 2008 Best's Insurance Reports — Property/Casualty xii (2008). A.M. Best's ratings run from A++ (the highest), to F (the lowest, for companies in liquidation). *Id.* at x.

[84] A.M. Best Report on AIG, note 8 above, at 1–2; *see also* A.M. Best Company, Inc., 2003 Best's Insurance Reports — Property/Casualty 215 (rating AIG insurance subsidiaries as "A++" and noting "[a]dded financial flexibility and access to capital markets is afforded by [their] ultimate parent — American International Group, Inc., a globally diversified leader in the insurance and financial services industry").

[85] A.M. Best Report on AIG, note 8 above, at 10.

[86] *Id.* at 8.

[87] *Id.*

[88] *See* A.M. Best Company, Inc., *AMB Credit Report — Insurance Professional (Unabridged) for AIG Casualty Company*, Sept. 15, 2008 (noting that each insurance company member of the commercial lines pool is assigned a rating of "A").

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These ratings are significant because many companies and contracts require insurance issued by an insurer with at least an "A" or "A-" rating.[89] A.M. Best continues to monitor the situation, and has placed the ratings of the insurance companies under review "with negative implications," meaning that they are considering whether to downgrade the insurers even more.[90] The negative outlook is due in part to concerns that policyholders will not place insurance with AIG insurers because of the uncertainty surrounding the parent company.[91] Thus, the performance of the AIG parent company has had a marked impact on the perceived financial stability of the insurance company subsidiaries, although other factors, such as the accumulation of significant reserves, can offset this effect.

2. The Financial Relationships Among AIG's Insurance Company Subsidiaries

The second factor affecting the finances of the property and casualty insurance companies is the fact that they are subject to what AIG refers to as "inter-company pooling" arrangements.[92] AIG's insurance companies are grouped into "inter-company pools," with some of the property and casualty insurers being divided into two pools: a "Commercial" pool consisting of nine insurance companies, and a "Lexington" pool consisting of three insurers.[93]

The companies are grouped into these pools because the insurers within each pool reinsure each other, with different insurers taking on different amounts of reinsurance for the other members of the pool.[94] As a result, the financial performances of the companies within each pool are tied together to a certain extent, since one company reinsures the other companies' losses. Thus, if one company has a particularly bad year in terms of losses for some reason, the other companies in the same pool can be adversely affected. As A.M. Best recognizes, "[s]urplus is compromised in the AIG companies by significant intracompany

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[89] *See* 2 Philip L. Bruner and Patrick J. O'Connor Jr., Bruner and O'Connor on Construction Law § 7:188 (2008); James E. Brannigan, *Insurance & Risk Management Due Diligence for Commercial Lending Transactions*, 535 PLI/Real 17, 57–58 (Practicing Law Institute 2007).

[90] *See* A.M. Best Company, Inc., *A.M. Best Maintains Under Review Negative Status on American International Group, Inc. Operations Designated for Sale*, Oct. 3, 2008 (available at http://www.reuters.com/article/pressRelease/ idUS150508+03-Oct-2008+BW20081003).

[91] *Id.*

[92] A.M. Best Report on AIG, note 8 above, at 3; Schimek, note 79 above, at 6.

[93] Schimek, note 79 above, at 7. The nine insurers in the Commercial pool are National Union Fire Insurance Company of Pittsburgh, Pa., Insurance Company of the State of Pennsylvania, Granite State Insurance Company, American Home Assurance Company, American International South Insurance Company, Commerce & Industry Insurance Company, AIG Casualty Company, New Hampshire Insurance Company, and Illinois National Insurance Company (sometimes referred to as the "National Union" pool). *Id.* The three insurers in the Lexington pool are Lexington Insurance Company, Landmark Insurance Company and AIG Excess Liability Insurance Company, Ltd. (sometimes referred to as the "surplus" or "excess" lines pool). *Id.*

[94] A.M. Best Report on AIG, note 8 above, at 3; Schimek, note 79 above, at 7.

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ownership of both insurance and non-insurance operating entities."[95] For this reason, A.M. Best usually rates all the AIG insurance companies in the same pool the same way in recognition of their interconnections.[96]

3. The Tangled Web: the Interconnections Between and Among AIG and Its Insurance Company Subsidiaries May Adversely Affect Their Performance

The interrelationships between and among AIG and its insurance company subsidiaries may end up adversely affecting the subsidiaries because of the way AIG intends to pay back the federal loan. AIG has announced its intention to sell off all of its assets except the domestic property and casualty insurance companies and foreign general insurance businesses.[97] AIG wants to continue to operate purely as a group of insurance companies, apparently having learned not to play with the fire of complex financial instruments. One question that arises: how will the rating agencies like A.M. Best rate this new, insurance-only entity? As has been seen, the financial strength of the parent company, including its financial products and aircraft leasing operating segments, had been a reason for confidence in the stability of the insurance subsidiaries. With a smaller parent company as a source of capital, should the insurers be rated the same way they are now? Will insurance buyers perceive this new entity with the same confidence as they had in the old AIG-backed insurers? Even if AIG is able to execute its plan as envisioned, pay off the loan and emerge as a group of solid, solvent insurance companies, it seems likely that it will have to spend some time convincing policyholders to place insurance with the new AIG.

It is by no means certain that AIG will be able to meet its goal. Everyone knows that AIG must find buyers quickly for its assets, but so far there have not been many deals announced. Some observers have noted that the prices AIG is asking for the assets right now (as of this writing in early December 2008) seem high, and that potential buyers are likely to get better deals by waiting.[98] AIG is not exactly in the strongest bargaining position. Moreover, many potential buyers likely do not have access to the necessary credit to finance a purchase, given the current unfavorable state of the credit market.[99] Therefore, there is a distinct possibility that AIG will not be able to raise all the cash it needs to pay back the loan by selling assets other than the property and casualty insurance companies.

The question then becomes, what would be the effect if AIG has to sell some

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[95] A.M. Best Report on AIG, note 8 above, at 9.

[96] *Id.*

[97] *See* AIG, note 61 above.

[98] *See* Ragnhild Kjetland, *DJ Aviva Priority on Current Ops; AIG Assets Expensive — Source*, Dow Jones International Newswire, Oct. 26, 2008 (accessed at http://fpn.advisen.com/?resource_id=84538067466993950#top); Paritosh Bansal, *AIG Asset Sale Gets Little Traction*, Reuters, Oct. 17, 2008 (available at http://www.reuters.com/article/newsOne/idUSTRE49F9NW20081017).

[99] Bansal, note 98 above.

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of its insurance company assets in order to pay back the loan? Given that the property and casualty insurers are interconnected by reinsurance within the various pools, it seems likely that all of the companies within a pool would be sold as a group, rather than individually. What entities have the ability and the desire to purchase these pools? Would these entities be viewed as secure enough to inspire confidence in the continued operations of the insurance companies? How would the financing for the sales be arranged? Would policyholders be willing to continue to buy insurance from the insurers when they are under new management? It is obvious that there are far more questions than answers at this point, and so the consequences of a possible sale of some AIG insurance companies can only be the subject of speculation. Suffice it to say that such a sale could have a significant impact on the financial performance and ratings of the insurers.

4. The Worst Case Scenario: Insurance Company Liquidations

Based on the foregoing, one must be cognizant of the possibility that one or more of the AIG insurance subsidiaries could eventually be liquidated. There are many less dire possibilities, including the continued normal operation of the insurance businesses, solvent run-off, or even regulatory supervision or rehabilitation. If the worst is to occur, it may be because consumers stop buying AIG insurance. For example, some combination of unfavorable events could cause A.M. Best and other rating agencies to downgrade the insurance companies below an "A-." Having its ratings fall below "A-" generally is disastrous for an insurance company selling commercial insurance. As noted previously, many corporations will not buy insurance from an insurance company with less than an "A-" rating, and most brokers do not recommend purchasing insurance from such insurers.[100] Consequently, when an insurance company's rating drops below "A-" many policyholders abruptly stop buying policies and premium revenue decreases. This creates a cash flow problem for the insurance company that causes further financial distress, resulting in further rating downgrades. The result is a rapid downward slide that can end in liquidation. In the last decade, the Reliance insurance companies, Kemper insurance companies and Legion Insurance Company have experienced this death spiral, with their ratings plummeting from "A-" to "E" in a matter of months.[101]

An order of liquidation is the end of the road for an insolvent insurance

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[100] 2 Philip L. Bruner and Patrick J. O'Connor Jr., note 89 above, at § 7:188; James E. Brannigan, note 89 above, at 57–58. Some courts hold that brokers have a duty to policyholders to place coverage with financially secure insurers and to apprise policyholders of adverse changes in insurers' financial condition. *See* Carter Lincoln-Mercury, Inc. v. Emar Group, Inc., 618 A.2d 870, 872 (N.J. App. Div. 1993), *aff'd*, 638 A.2d 1288 (N.J. 1994); Central General Hospital v. Bramex, Ltd., 570 N.Y.S.2d 670, 670 (App. Div. 2d Dept. 1991).

[101] The rapid demise of the Reliance companies, Kemper companies and Legion Insurance Company can be tracked through the press releases that A.M. Best released each time it downgraded these companies. These press releases can be found at, among other sites, http://www.insurancejournal.com.

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company. It is akin to a Chapter 7 proceeding, although insurance companies are exempt from the federal Bankruptcy Code.[102] The insurance commissioner gathers the assets of the insolvent company, collects proof of claim forms from policyholders and other creditors, and eventually (many years later) pays out the company's remaining assets to the policyholders and other creditors.[103] When an insurance company enters liquidation, or in some instances whenever a finding of insolvency is made, guaranty associations in the various states are called upon to respond.[104]

The proof of claim process is the manner by which policyholders can obtain a direct distribution from the estate of the liquidating insurance company.[105] The liquidator of a liquidating insurance company will send proof of claim forms to policyholders and known claimants and establish a proof of claim deadline.[106] Claims filed after the deadline may be penalized by being granted a lower priority in the distribution scheme, which could be the difference between some recovery and no recovery.

After the proof of claim form is filed, the liquidator can approve or reject the claim. The liquidator will assign a priority to the claim in accordance with the priorities established in the liquidation statute.[107] Generally, administrative expenses of the estate are the highest priority, with claims for losses under insurance policies next, followed by other types of claims, such as general creditor claims.[108] Administrative expenses are paid on a regular basis throughout the liquidation. Eventually, often after years have passed, the liquidator will begin making distributions to policyholders. In most insolvencies, the policyholder class of claimants will never receive full satisfaction and any claimant holding a claim

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[102] *See* 11 U.S.C. §§ 109(b)(2), (d); Hartford Cas. Ins. Co. v. Borg-Warner Corp., 913 F.2d 419, 421 (7th Cir. 1990) (noting that liquidation of an insurer under state law is similar to federal bankruptcy proceedings).

[103] *See* Kent M. Forney, *Insurer Insolvencies and Guaranty Associations*, 43 Drake L. Rev. 813, 819–823 (1995). In Pennsylvania, where AIG's flagship National Union Fire Insurance Company of Pittsburgh, Pa. is located, the liquidation of an insurance company is governed by state statute. *See* 40 Pa. Stat. § 211, *et seq.* Pennsylvania, along with many other states, has adopted the NAIC's Insurer Receivership Model Act, and its law is representative of typical state insurance insolvency law.

[104] Forney, supra note 103 at 823–28. In Pennsylvania, as in many other states, there are separate guaranty associations for life and health insurance, 40 Pa. Stat. § 991.1701, *et seq.*, and property and casualty insurance, 40 Pa. Stat. § 991.1801, *et seq. See generally* NAIC, NAIC Compendium of State Laws on Insurance Topics III-IN-10, IN-15, IN-30, IN-35 (2006) [hereinafter NAIC Compendium of State Laws] (summarizing provisions of state insurance guaranty laws). Some states, like Pennsylvania, also provide a separate security fund or guaranty association for workers' compensation insurance. *See* NAIC Compendium of State Laws at III-IN-30.

[105] *See, e.g.*, 40 Pa. Stat. §§ 221.37, 221.38.

[106] Forney, note 103 above, at 823.

[107] *Id.*

[108] *See, e.g.*, 40 Pa. Stat. § 221.44.

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that has been assigned a lower priority than the policyholder classification will receive no payment.

If the liquidator rejects the claim or assigns it a lower priority than warranted, a policyholder may object to the proof of claim determination.[109] There are often short timelines of 30 or 60 days for filing such objections. The court may assign a referee to find facts and make a report and recommendation on the controversy. Ultimately, the objection will be decided in the judicial system through a court's acceptance or rejection of the referee's report and recommendation.

By statute, states have created guaranty associations as a safety net to pay claims owed by insolvent insurance companies.[110] Guaranty associations are generally charged by statute to avoid excessive delay in payments and to alleviate financial loss to claimants and policyholders because of an insurance company's insolvency.[111] Although the requirements for obtaining recovery from state guaranty associations vary, there are many similarities.[112]

At the heart of nearly every guaranty association statute is the definition of "covered claim." Generally, a covered claim is one that falls within the coverage and limits of an insurance policy sold by the insolvent insurance company.[113] Most statutes, however, allow the payment of a covered claim only in amounts between $100 and $300,000.[114] Often, workers' compensation claims are not subject to these limits and will be paid in full by the guaranty association.[115]

Many guaranty association statutes have provisions which may limit or prevent recovery for a policyholder with a "net worth" of more than $25 million or $50 million.[116] The term "net worth" is normally undefined in these statutes, leading to controversy. Additionally, many net worth provisions make a distinction between "first-party" claims, such as property insurance claims, and "third-party" claims, such as general liability claims.[117] The net worth provisions may not affect the guaranty association's duty to investigate, handle and pay third-party claims. In many instances, the net worth provision gives the guaranty association the right to recover from the policyholder any amounts that the guaranty association

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[109] *See* 40 Pa. Stat. § 221.41.

[110] Forney, note 103 above, at 823; NAIC Compendium of State Laws, note 104 above, at III-IN-10, IN-15, IN-30, IN-35.

[111] *See* 40 Pa. Stat. § 991.1801.

[112] The website for the National Conference of Insurance Guaranty Funds (www.ncigf.org) is a very helpful source of information concerning the substantive and procedural aspects of insurance guaranty laws.

[113] *See* 40 Pa. Stat. § 991.1802.

[114] *See* NAIC Compendium of State Laws, note 104 above, at III-IN-30; 40 Pa. Stat. § 991.1803.

[115] Forney, note 103 above, at 825.

[116] *See* NAIC Compendium of State Laws, note 104 above, at III-IN-30; 40 Pa. Stat. § 991.1802.

[117] *Compare* 40 Pa. Stat. § 991.1802 *with* 40 Pa. Stat. § 991.1816.

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ultimately pays to resolve the claim.[118] If so, it does not alleviate the guaranty association's duty to investigate and handle the claim, without reimbursement from the policyholder.

In some instances, it is possible to recover directly from the reinsurance companies who reinsured the policyholder's insurance program. Rarely, a reinsurance contract will contain a "cut-through" clause specifically authorizing payment directly to a policyholder in the event of the insolvency of the insurance company.[119] Whenever the policyholder can properly be considered to be the intended beneficiary of the reinsurance contract, the policyholder may recover directly from its reinsurance companies.[120]

Umbrella insurance policies often have explicit statements that they will not drop down to provide primary coverage when the primary insurance becomes insolvent. Where there is no clear and unambiguous expression of that intent in the umbrella insurance policy, policyholders have sometimes successfully obtained recovery from their umbrella insurance company for amounts that would have been covered by the insolvent insurance company.[121]

Policyholders faced with an insurance insolvency may also need to evaluate whether their insurance broker acted within the standard of care of the insurance brokerage industry. An insurance broker has a duty to ensure that the insurance company is licensed and solvent.[122] The standards of the insurance brokerage industry include a duty to warn the policyholder if the broker knows or should have known of the financial instability or insolvency of the insurance company. The judicial precedent around the country is in conflict with regard to whether a broker owes a continuing duty to warn of financial instability during the policy period or thereafter.[123] Such financial instability may include rating downgrades or other objective indicia of increased risk of insolvency. For many courts, the question turns upon the closeness of the relationship between broker and

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[118] *See* 40 Pa. Stat. § 991.1816.

[119] *See* Koken v. Legion Ins. Co., 831 A.2d 1196, 1224 (Pa. Cmwlth. Ct. 2003), *aff'd*, 878 A.2d 51 (Pa. 2005).

[120] *Koken,* 831 A.2d at 1236–37.

[121] *See, e.g.,* Weaver v. Kitchens, 556 So. 2d 120 (5th Cir. 1990) (requiring umbrella insurance company to cover all loss in excess of guaranty association payment). *See also* Amy M. Samberg, *Drop Down Liability of Excess Insurers for Insolvent Primary Carriers: The Search for Uniformity in Judicial Interpretation of Excess Insurance Policies*, 33 Ariz. L. Rev. 239 (1991).

[122] *See* MacGillivary v. W. Dana Bartlett Ins. Agency of Lexington, Inc., 436 N.E.2d 964, 969 (Mass. App. Ct. 1982); Williams-Berryman Ins. Co. v. Morphis, 461 S.W.2d 577, 580 (Ark. 1971).

[123] *See* Carter Lincoln-Mercury, Inc., Leasing Div. v. EMAR Group, Inc., 638 A.2d 1288 (N.J. 1994); Higginbotham & Assocs., Inc. v. Greer, 738 S.W.2d 45 (Tex. App. 1987); *Morphis*, 461 S.W.2d at 580; Central Gen. Hosp. v. Bramex, Ltd., 174 A.D.2d 556, 570 N.Y.S.2d 670 (1991); New York Health & Racquet Club, Inc. v. NIA/Kornreich Ltd. Liab. Co., 736 N.Y.S.2d 369 (App. Div. 2002); Cateora v. British American Assurance, Ltd., 282 F. Supp. 167 (S.D. Tex. 1968); Glenn v. Leaman & Reynolds, Inc., 442 So. 2d 1224 (La. Ct. App. 1983).

policyholder and the reasonable reliance of the policyholder on the special expertise and knowledge of the broker.

B. Changing the Rules of the Game: Federal Regulation of the Insurance Industry

The financial collapse of AIG has had and will continue to have significant impacts on the financial services industry, including the regulation of that industry. Although AIG stresses that its insurance company subsidiaries are well capitalized and have a collective surplus of $26.7 billion available to pay claims,[124] it is reasonable to suppose that the enormous size of AIG's losses[125] alone would have some impact on the insurer subsidiaries' ability to operate in the future. For example, A.M. Best has commented that its financial strength, issuer credit and debt ratings for AIG's insurance companies remain under review with negative implications due to the continuing financial problems of the parent company and uncertainty over whether the federal bailout will succeed.[126] Moreover, AIG's collapse highlights the extent to which insurance has become intertwined with other aspects of the financial services industry, including the markets for securities, futures, collateralized debt obligations, credit default swaps, and other complex financial instruments. The high stakes at risk due to AIG's financial collapse have reinvigorated the debate over whether the federal government should play a role in regulating the business of insurance.[127]

1. The Current Situation: the States' Historic Role in Regulating the Business of Insurance Has Resulted in Fifty Rule Books and No Referee

In 1869, the United States Supreme Court ruled that "issuing a policy of insurance is not a transaction of commerce" for purposes of the constitution's Commerce Clause.[128] This left the states free to regulate the business of insurance without much interference from the federal government. What evolved was a scheme in which each of the states developed its own agencies, laws and regulations to regulate insurance over the next 75 years, including the creation of

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[124] *See* Schimek, note 79 above, at 9; Andrew G. Simpson, *AIG Commercial Insurance Unit Financially Fit and Fighting Back*, Insurance Journal, Oct. 14, 2008 (available at http://www.insurancejournal.com/news/national/2008/10/14/94620.htm).

[125] Federal loans to AIG are now at $150 billion (as of this writing in early December 2008), and AIG may borrow still more. *See* Walsh, note 65 above; Board of Governors of the Federal Reserve System, note 74 above; Hays & Ruquet, note 74 above, at 6.

[126] *See* A.M. Best Company, Inc., note 90 above.

[127] *See AIG Crisis Restarts Debate Over State vs. Federal Insurance Regulation*, Insurance Journal, Sept. 17, 2008 (available at http://www.insurancejournal.com/news/national/2008/09/17/93798.htm) [hereinafter *AIG Crisis Restarts Debate*]; Mark A. Hofman, *Bailout Drama Fuels Debate on Regulation of Insurance*, Business Insurance, Sept. 28, 2008 (available at http://www.businessinsurance.com/cgibin/article.pl?articleId=26019&a=a&bt=bailout+ rama).

[128] Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183, 19 L. Ed. 357 (1869).

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the National Association of Insurance Commissioners ("NAIC") in 1871.[129] However, in 1944 the Supreme Court reversed itself, holding that, whatever the accuracy of the Court's description of insurance in the nineteenth century, by the middle of the twentieth century it was obvious that the business of insurance included interstate commerce and thus fell within the reach of federal laws and regulations, including antitrust laws.[130]

The insurance industry and the states feared that the Supreme Court's 1944 decision heralded the onset of intensive federal regulation of insurance that would upset the existing scheme.[131] Therefore, insurance companies and the states lobbied Congress for a law that would restore the status quo.[132] In 1945 they were rewarded with the McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq.*, which provides that,

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance. . . .[133]

The McCarran-Ferguson Act reverses the normal precedence of laws and provides that state laws regulating the business of insurance pre-empt federal laws that may impact insurance, except for federal laws that specifically concern insurance. This "reverse pre-emption" effectively returned to the states the right to regulate insurance.[134]

The states (along with the District of Columbia and five territories) have continued to hold the field in regulating insurance from 1945 to the present day. The result is a patchwork of laws and regulations individually enacted and enforced by the states. Although the NAIC promulgates and promotes uniform standards for such laws and regulations,[135] it has no authority to enact or enforce them. Even a brief perusal of state laws and regulations reveals significant differences among the states on many insurance issues.[136]

Previous federal involvement in the regulation of insurance has been limited. In the late 1980s and early 1990s the failure of several prominent insurance companies prompted a Congressional study into the causes of the failure and

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[129] *See* Eric C. Nordman, *The Early History of the NAIC*, 19 J. Ins. Reg. 164 (2000).

[130] United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 551–53, 64 S. Ct. 1162, 1172–73, 88 L. Ed. 1440 (1944).

[131] *See* Blackfeet Nat'l Bank v. Nelson, 171 F.3d 1237, 1245 (11th Cir. 1999).

[132] *Id.*

[133] 15 U.S.C. § 1012(b).

[134] *See generally* United States Dept. of the Treasury v. Fabe, 508 U.S. 491, 113 S. Ct. 2202, 124 L. Ed. 2d 44 (1993); SEC v. National Sec., Inc., 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969).

[135] *See, e.g.,* NAIC, Model Laws, Regulations and Guidelines (2008).

[136] *See, e.g.*, NAIC, Compendium of State Laws, note 104 above.

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proposals for a federal regulatory system.[137] These proposals, however, did not directly lead to any significant federal regulations. In 1999, Congress passed the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act ("FSMA").[138] The FSMA allowed commercial banks, investment banks and insurance providers to consolidate, creating the modern financial services industry.[139] The FSMA reaffirmed the states' right to regulate insurance and protects 13 specific areas of state insurance regulation from federal preemption.[140] The FSMA also required the states to enact uniform insurance agent licensing laws and reciprocity measures.[141]

2. The Debate: Do We Need a Federal Umpire to Regulate the Playing Field of the Modern, International Insurance Industry?

In 2007 the United States Treasury Department conducted a comprehensive study of the regulatory structure in place for the financial services industry, including insurance. This study culminated in the Treasury Department's March 2008 report, "Blueprint for a Modernized Financial Regulatory Structure." With respect to the insurance industry, the Treasury Department concluded that the state-based regulatory system is not the most efficient or effective way to regulate an industry that has become global in its scope.[142] AIG is a very large player in this global insurance market. Policyholders from all over the world buy insurance from AIG insurers, and the insurance covers equally globe-spanning operations. For example, a Swedish company with subsidiaries in the United States might use a London broker to buy insurance from an AIG company to insure operations in all 50 states. Thus, international negotiations and exchanges are commonplace in the modern insurance industry. However, there currently is no regulatory official at the federal level that can speak on behalf of U.S. regulators regarding areas of national and international concern.

The Treasury Department also recognized that insurance is only one aspect of the broader financial services industry, and that the lines dividing banking, securities, futures and insurance have become increasingly blurred.[143] Thus, the current "functional" division of regulatory responsibility among these industry

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[137] *See* House Subcomm. on Oversight and Investigations, Comm. on Energy and Commerce, 101st Cong., *Failed Promises: Insurance Company Insolvencies* (Comm. Print 1990).

[138] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[139] Pub. L. No. 106-102 §§ 101-02, 113 Stat. 1341.

[140] Pub. L. No. 106-102 § 104(d)(2)(B), 113 Stat. 1353–56.

[141] Pub. L. No. 106-102 § 321, 113 Stat. 1422.

[142] U.S. Dept. of the Treasury, Blueprint for a Modernized Financial Regulatory Structure 9-10 (2008) [hereinafter Treasury Department Blueprint]. The complete text of the Treasury Department Blueprint is available on the Department's website at http://www.treas.gov/press/releases/reports/Blueprint.pdf.

[143] *Id.* at 3–5.

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sectors has the risk of creating conflicts among the responsible agencies and gaps in the regulatory schemes.[144]

In order to address these deficiencies, the Treasury Department recommends establishing an optional federal charter ("OFC") that would provide a system of federal chartering, licensing, regulation and supervision of insurers, reinsurers and insurance producers.[145] Insurers, reinsurers and insurance producers could opt for federal regulation or remain in the existing state system.[146] The Treasury Department also recommends creating an Office of National Insurance ("ONI") and an Office of Insurance Oversight ("OIO").[147] The ONI would create and oversee the necessary regulatory, supervisory, enforcement, and rehabilitative powers of the OFC.[148] The OIO would promote international insurance regulatory policy for the United States and serve as an advisor to the Secretary of the Treasury on major domestic and international insurance policy issues.[149] In short, the Treasury Department is in favor of a comprehensive scheme of federal regulation that would replace much, if not all, of the existing state-based regulatory regime.[150]

Reaction to the Treasury Department's recommendations has been mixed. The NAIC, not surprisingly, is not in favor of the OFC approach.[151] Apart from the understandable aversion to having the powers of the state insurance commissioners significantly reduced, the NAIC points to the financial strength of AIG's insurance subsidiaries as proof that the state regulatory scheme works to ensure that insurance companies are insulated from adversity in their parent companies.[152] However, had the state insurance commissioners timely recognized that credit default swaps are a form of insurance subject to their powers of regulation,

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[144] *Id.* A real world example of a regulatory "gap" is the credit default swap, the financial instrument at the root of AIG's collapse. As discussed above, a credit default swap is like insurance for default on a debt like a municipal bond or a security backed by debt obligations (*e.g.*, mortgage-backed securities). Neither the federal government nor the states regulated the credit default swap market worth trillions of dollars.

[145] Treasury Department Blueprint, note 142 above, at 10.

[146] *Id.*

[147] *Id.* at 10–11.

[148] *Id.* at 11.

[149] *Id.*

[150] The Treasury Department does note that insurers could still be subject to continued compliance with some state laws, such as tax laws, compulsory coverage for workers' compensation and individual auto insurance, and participation in mandatory residual risk mechanisms and guarantee funds. *Id.* at 10.

[151] *See* NAIC, *NAIC Response to Treasury Report*, Mar. 31, 2008 (available at http://www.naic.org/Releases/2008_ docs/praeger_response_treasury_report.htm); NAIC, *NAIC Offers Views on Three Insurance Bills at Subcommittee Mark-Up*, July 9, 2008 (available at http://www.naic.org/Releases/2008_docs/insurance_bills_mark_up.htm) ("'Every insurance commissioner strongly believes that an OFC is the worst possible public policy choice for insurance.'")

[152] *See* NAIC, *State Regulators: AIG Insurers Able to Pay Claims*, Sept. 17, 2008 (available at

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arguably AIG's financial collapse could have been avoided or at least substantially mitigated. The NAIC's belated admission that insurance regulations apply at least to some types of credit default swaps is a classic case of closing the stable door after the horses have bolted, and moreover still leaves approximately 90% of all credit default swaps unregulated.[153] Current discussions among federal and state regulators and legislators on how to regulate credit default swaps, and whether the Securities and Exchange Commission, the Commodity Futures Trading Commission, the state insurance departments, or some combination of federal and state regulators, should be responsible for regulating credit default swaps, highlight the need for a more systematic and broader level of regulation.[154]

Other observers have expressed concern over the state regulators' initial response to the AIG financial crisis, which was to agree to a plan where AIG would obtain $20 billion of its insurance subsidiaries' investment-grade securities in exchange for securities of questionable liquidity so that AIG could use the investment-grade securities as collateral.[155] One key motivation was the desire to protect, not the insurance companies or policyholders, but the jobs of thousands of AIG employees in the state of New York.[156] This demonstrates that state regulators are susceptible to local political and economic concerns that may interfere with the ability to make decisions that affect insurance companies and policyholders nationally and internationally.

The NAIC was created "to address the need to coordinate regulation of multistate insurers," and one of its primary goals is "the development of uniform policy when uniformity is appropriate."[157] To the extent that the NAIC claims success in coordinating the regulation of multistate insurers (which includes most insurance companies now) and developing uniform policies for the regulation of insurance that apply throughout the United States, this very success can be viewed as an argument in favor of a national regulatory system. The NAIC essentially is a trade organization that "assists" state insurance commissioners in regulating insurance.[158] It has no enforcement powers and no authority over the insurance commissioners or insurance companies. The cooperation of the individual insurance commissioners and their willingness to accept uniform insurance policies developed within the NAIC structure indicate the commissioners'

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http://www.naic.org/ Releases/2008_docs/AIG_pay_claims.htm); *AIG Crisis Restarts Debate*, note 127 above.

[153] *See* R.J. Lehmann, *NAIC Proposes Insurers Disclose Swaps, Other Derivatives*, BestWire Services, Oct. 29, 2008 (accessed at http://fpn.advisen.com/articles/article84666243-1334308299.html).

[154] *Id.*

[155] *See* Hilzenrath & Goldfarb, note 81 above.

[156] *Id.*; Lilla Zuill, *AIG Gets New York's Help in Accessing $20 Billion*, Reuters, Sept. 15, 2008 (available at http:// www.reuters.com/article/ousiv/idUSN1440161120080915?sp=true).

[157] *See* http://www.naic.org/index_about.htm.

[158] *Id.*

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recognition of the need for such uniformity. A federal insurance regulator not only would develop the needed uniform policies but would be able to implement and enforce them as well. The OFC/ONI approach would create a truly national set of uniform laws and rules that coordinate the regulation of multistate and multinational insurance companies. The NAIC is seeking to achieve this same result, but without the ability to impose that regulation throughout the country. Thus, a federal insurance office would at least theoretically be better placed to accomplish the NAIC's goals.

For example, in response to the AIG financial crisis the NAIC has created an "AIG Special Task Force," comprised of all NAIC members, which is charged with "overseeing the regulatory activities related to the AIG insurance subsidiaries and coordinating interaction among state regulators, federal government officials, company representatives, and international regulatory interests."[159] Had a federal Office of National Insurance existed at the time AIG's financial problems surfaced, it already would have been overseeing the regulatory activities related to the AIG insurance subsidiaries (assuming they had opted in to the federal charter) and coordinating the interaction among all affected entities. This interaction also would have been more efficient because the involvement of 50 different state insurance commissioners would have been greatly reduced.

Other insurance organizations support the Treasury Department's OFC approach. The American Insurance Association ("AIA"), the leading property and casualty insurance trade organization in the United States,[160] and the Risk and Insurance Management Society, Inc. ("RIMS"), the professional association for corporate and government risk managers,[161] both are in favor of an OFC.[162] These entities believe that an OFC regulatory scheme would modernize the insurance industry, allow insurers to develop and deliver products more efficiently and effectively, and increase competition.[163]

Currently there are several bills pending before Congress that would effectuate some federal regulation of insurance to a greater or lesser degree. The National Insurance Act of 2007 would put in place an OFC regulatory system substantially similar to the one subsequently recommended by the Treasury Department in its Blueprint.[164] The Insurance Information Act of 2008 proposes the creation of an

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[159] *See* http://www.naic.org/committees_ex_aig.htm.

[160] *See* http://www.aiadc.org/aiapub/landing.aspx?m=1.

[161] *See* http://www.rims.org/aboutRIMS/Pages/MissionandDescription.aspx.

[162] *See* RIMS, *RIMS Reinforces Support of Optional Federal Charter Legislation*, July 26, 2007 (available at http://www.rims.org/governmentaffairs/Statements/Pages/federalcharter07-26-07.aspx); AIA, *AIA Applauds Recommendation of "OFC" in Blueprint*, Mar. 29, 2008 (available at http://www.aiadc.org/aiadotnet/ docframe.aspx?docid=313071).

[163] *Id.*

[164] *See* S. 40, 110th Cong. (2007); H.R. 3200, 110th Cong. § 1102(b) (2007) (describing the powers of the Commissioner of National Insurance).

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Office of Insurance Information ("OII") within the Treasury Department.[165] The OII would collect, analyze, and disseminate information and issue reports regarding insurance, establish federal policy on international insurance matters, and advise the Treasury Secretary on major domestic and international insurance policy issues.[166] The Insurance Information Act can be seen as an intermediate step on the way to establishing the full OFC regulatory scheme. The Nonadmitted and Reinsurance Reform Act of 2007 would streamline the regulation of nonadmitted insurance and reinsurance by applying single-state regulation and uniform standards to nonadmitted[167] insurers and reinsurers.[168]

The insurance industry has changed in many dramatic and fundamental ways since 1869. In contrast, the current system of regulation in the United States, in which each state is individually responsible for regulating insurance, essentially has been unchanged for the past 139 years. The globalization of insurance markets and the increasing interrelationships of insurance and other financial products designed to hedge or mitigate risk are strong arguments in favor of modernizing the current system to some degree. Whether a comprehensive OFC/ONI approach will be enacted remains to be seen, but it seems likely that some form of federal insurance regulation eventually will be in place to address the real and perceived inefficiencies in the state-based regulatory system and the need for true national regulation of insurance in the modern financial world.

C. Regulating Credit Default Swaps as Insurance

There is an old saying making the point that substance matters over form: "if it walks like a duck, quacks like a duck, and looks like a duck, then it's a duck."[169] Credit default swaps have several aspects that are substantially similar to what is traditionally thought of as insurance, making them very much like that particular duck. These aspects would lead one to conclude that credit default swaps can and should be regulated as insurance products, whether under the current state-based

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[165] *See* H.R. 5840, 110th Cong. (2008).

[166] H.R. 5840, 110th Cong. § 313(c)(1)–(2).

[167] Insurers that are licensed to conduct business in a state are known as "admitted" insurers. *See* Jeffrey W. Stempel, Stempel on Insurance Contracts § 22.01[B] (3d ed. 2005) [hereinafter Stempel on Insurance Contracts]. Licensed insurers are subject to the regulations of the states in which they are licensed. *Id.* Unlicensed insurers are known as "nonadmitted" or "surplus lines" insurers, and are not subject to most state regulations. *Id.* Nonadmitted insurers are generally prohibited from doing business in a state unless they are selling insurance that is otherwise unavailable from licensed insurers. *Id.* They cannot solicit business, but licensed brokers can approach them seeking coverage on behalf of insureds. *Id.* Most nonadmitted insurers are domiciled in Europe or Bermuda. *Id.* The existence of this large insurance market that is beyond the reach of state regulators is another reason in favor of federal regulation of insurance.

[168] *See* S. 929, 110th Cong. (2007); H.R. 1065, 110th Cong. (2007).

[169] *See* Sierra Club v. Flowers, 526 F.3d 1353, 1359 (11th Cir. 2008). Abraham Lincoln purportedly made the same point in equally colorful language: "If you call a tail a leg, how many legs has a dog? Five? No, calling a tail a leg don't *make* it a leg." *See* Hyperquest, Inc. v. N'Site Solutions, Inc., 559 F. Supp. 2d 918, 920 n.6 (N.D. Ill. 2008).

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system or in an OFC regime. However, credit default swaps also are dissimilar to insurance in important respects, meaning that it is by no means certain that they are, in fact, ducks. Moreover, regulating credit default swaps as insurance could have an enormous impact on their use as a financial instrument that greatly restricts their utility and worth as vehicles to hedge investments. Resolving the questions of whether and how to regulate credit default swaps as insurance requires an analysis of what the concept of "insurance" includes, how credit default swaps do and do not fit this concept, and the ramifications of regulation on the industry.

1. The Essential Elements of Insurance

There is, of course, no fixed or universally accepted definition of "insurance," which of necessity is a broad and flexible concept that varies depending on the context.[170] Nevertheless, without getting bogged down in the intricacies of the subject, for purposes of this article it is possible to discern some elements that generally are considered necessary (though perhaps not sufficient) in order for a transaction to qualify as "insurance." First, and most importantly, there must be a transfer and distribution of risk.[171] Second, the person buying the insurance should have an "insurable interest" in what is being insured.[172] Third, the insurance should compensate the buyer for a loss (known as the "principle of indemnity").[173]

Of these three elements, the transfer and spreading of risk is widely recognized as ***the*** fundamental purpose of insurance.[174] As one treatise puts it, risk transfer and distribution is the "keystone to the nature of insurance."[175] "Risk" can be defined as the possibility that a loss outside the control of the parties to the contract may occur.[176] Risk is transferred in an insurance transaction when the buyer pays the seller a premium, in exchange for which the seller agrees to pay the buyer a sum of money if the loss occurs.[177] The seller typically then distributes

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[170] Eric Mills Holmes and Mark S. Rhodes, Holmes' Appleman on Insurance 2d § 1.3, at 9–10 [hereinafter Holmes' Appleman on Insurance 2d].

[171] Holmes' Appleman on Insurance 2d § 1.3, at 10–11; Robert E. Keeton and Alan I. Widiss, Insurance Law § 1.3, at 11–12 (1988) [hereinafter Insurance Law].

[172] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11–16; Insurance Law, note 171 above, § 3.1, at 135–136.

[173] Holmes' Appleman on Insurance 2d § 1.4, at 24–25; Insurance Law § 3.1, at 135; Emeric Fischer, et al., Principles of Insurance Law (revised 3d ed. 2006) § 1.04, at 55–57 [hereinafter Principles of Insurance Law].

[174] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 10; Principles of Insurance Law, note 173 above, § 1.02, at 14.

[175] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 10; *see also* Principles of Insurance Law, note 173 above, § 1.02, at 14 ("The very reason for having insurance is to spread risk.").

[176] *See* Stempel on Insurance Contracts, note 167 above, § 1.03[A].

[177] Principles of Insurance Law, note 173 above, § 1.02, at 15.

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this risk by collecting premiums from many buyers with similar risks, creating a pool of money that will be used to pay claims.[178] Proper underwriting of insurance consists mainly of adequately estimating the risk that losses will occur and the amounts of those losses, and collecting sufficient premiums from enough policyholders to have enough money available to pay those expected losses and (hopefully) make a profit.[179]

The buyer of insurance has an "insurable interest" in the thing being insured if he has a substantial risk of experiencing financial detriment if the insured loss occurs.[180] The purpose of this element is to prevent persons from profiting from a loss in which they have no direct interest.[181] Within a hundred years of the start of the modern insurance industry in Lloyd's coffee house in seventeenth century London, it was common for people to purchase "insurance" on all sorts of events, from the cancellation of a coronation to the death of a nobleman.[182] In effect, insurance became a type of gambling on the misfortune of others.[183] The unseemliness of these legalized "dead pools" was obvious, not to mention the risk that a person might try to cause the event in question in order to collect on his policy.[184] Legislatures and courts soon put a stop to it by requiring the buyer of insurance to have a pecuniary interest in the object of the insurance in order for the contract to be valid.[185]

Closely related to the "insurable interest" requirement is the "principle of indemnity," which states that insurance is intended to indemnify someone for their actual monetary loss.[186] This ensures that the policyholder does not make a profit if the insured event occurs.[187] Otherwise, the policyholder might be tempted to be less careful than she otherwise would be, in the hope of getting a windfall from the insurance proceeds.[188] In extreme cases, the policyholder may attempt to

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[178] *Id.*

[179] *Id.*

[180] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 14; Insurance Law, note 171 above, § 3.1, at 135.

[181] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11–13; Insurance Law, note 171 above, § 3.1, at 136–138.

[182] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11–13; Insurance Law, note 171 above, § 3.1, at 136–138; Stempel on Insurance Contracts, note 167 above, § 1.05[A].

[183] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11–13; Insurance Law, note 171 above, § 3.1, at 136–138.

[184] Stempel on Insurance Contracts, note 167 above, § 1.05[A].

[185] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11–13; Insurance Law, note 171 above, § 3.1, at 136–138; Stempel on Insurance Contracts, note 167 above, § 1.05[A].

[186] Insurance Law, note 171 above, § 3.1, at 135; Principles of Insurance Law, note 173 above, § 1.03, at 55.

[187] Insurance Law, note 171 above, § 3.1, at 135; Principles of Insurance Law, note 173 above, § 1.03, at 55.

[188] Insurance Law, note 171 above, § 3.1, at 138.

cause the insured event to occur.[189] Compensating the policyholder only for her actual loss, along with the requirement that the policyholder have an insurable interest, reduces this "moral hazard," as it is termed in the insurance industry.[190]

2. Credit Default Swaps Have Some, but Not All, of the Elements of Insurance

Descriptions of credit default swaps in the media, financial services industry sources and court cases generally state that they are a form of, or similar to, insurance. For example, one court recently found that:

> A credit default swap is an arrangement similar to an insurance contract. The buyer of protection . . . pays a periodic fee, like an insurance premium, to the seller of protection . . . in exchange for compensation in the event that the insured security experiences default.[191]

Such descriptions make it clear that credit default swaps exhibit the principal, fundamental element of insurance: the transfer and distribution of risk. As originally structured, buyers of credit default swaps owned bonds or other securities and were concerned about the risk of the issuers of the securities defaulting on them.[192] The security holders thus bought credit default swaps that would pay them the value of the securities in the event of default.[193] In other words, the buyers transferred the risk of default to the sellers of the credit default swaps in exchange for guaranteed payments. The sellers distributed this risk by selling credit default swaps to many buyers. In their function as vehicles to transfer and distribute risk, credit default swaps are indistinguishable from insurance.[194]

Credit default swaps are not actually tied to the underlying securities, but only reference them (the underlying securities thus are known as "reference

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[189] *Id.*

[190] Principles of Insurance Law, note 173 above, § 1.04, at 85.

[191] Merrill Lynch Int'l v. XL Capital Assur., Inc., 564 F. Supp. 2d 298, 300 (S.D.N.Y. 2008); *see also* Bomfim, note 28 above, at 68 ("a credit default swap shares many similarities with traditional insurance products"); Pinsent, note 28 above ("A CDS contract can be used as a hedge or insurance policy against the default of a bond or loan."); Neal & Rolph, note 31 above, at 10 (credit default swaps "provide insurance against credit-related losses"); Morgenson *Arcane Market*, note 27 above (quoting an executive of a capital management company describing the credit default swap market as "a giant insurance industry that is underregulated and not very well reserved for and does not have good standards as a result").

[192] Bomfim, note 28 above, at 68–69; Pinsent, note 28 above; Tavakoli, note 28 above, at 66.

[193] Masters & Bryson, note 30 above, at 48.

[194] *See* David K.A. Mordecai, *The Use of Credit Derivatives in Credit-Enhanced & Credit Linked Structured Notes: A Former Rating Analyst's Perspective*, *in* The Handbook of Credit Derivatives, note 30 above, at 339 (including credit default swaps among the types of instruments, including insurance, that are used to transfer and spread risk); Tavakoli, note 28 above, at 72 (stating that the "whole point" of using credit derivatives is to "diversify credit risk").

entities").[195] A credit default swap will pay out whenever the credit event occurs to the reference entity, regardless of who owns the swap.[196] This means that both the original buyers and the original sellers can in turn sell their respective ends of the transactions to other entities, who can sell them again, and so on multiple times.[197] As a result, the entity that ends up owning a particular credit default swap often will not own or have an interest in the reference entity. This means that the owner may not have an insurable interest in the underlying security and probably will not suffer a direct pecuniary loss from the default of the reference entity. As such, many credit default swaps violate the insurable interest requirement and the principle of indemnity for insurance contracts.

3. Should Quasi-Insurance Credit Default Swaps Be Regulated as Insurance Products?

Companies that both own credit default swaps and either own or have some substantial interest in the reference entities would seem to have an insurable interest in those entities and be at risk of pecuniary loss in the event of default or other credit event concerning the reference entities. These credit default swaps, then, appear to have all of the commonly accepted elements of insurance — risk transfer, insurable interest and indemnity for actual loss — and thus can be regulated as insurance products. Indeed, the state insurance commissioners have now (perhaps belatedly) recognized that they have the power to regulate at least these kinds of credit default swaps and are in the process of formulating regulations to do so.[198]

However, by one estimate up to 90 percent of credit default swaps are owned by entities that do not have a direct interest in the reference entities.[199] As these credit default swaps appear to violate the insurable interest requirement and the principle of indemnity, does that mean that state insurance departments have no authority to regulate them? Not necessarily.

It is not clear that insurable interest and indemnity for actual loss are so integral to the concept of insurance that if a contract does not have these elements it cannot be regulated as insurance. Some states do not define insurance under their regulatory schemes as requiring an insurable interest for all or some types of insurance. For example, Colorado's insurance law defines "insurance" as:

> a contract whereby one, for consideration, undertakes to indemnify another or to pay a specified or ascertainable amount or benefit upon determinable risk contingencies, including annuities.[200]

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[195] Pinsent, note 28 above.

[196] *Id.*

[197] *Id.*

[198] *See* Lehmann, note 153 above.

[199] *Id.*

[200] Colo. Rev. Stat. § 10-1-102(7). By contrast, other states do include the insurable interest

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Under this definition, one may not need to have an interest in the thing being insured in order to receive payment of "a specified or ascertainable amount or benefit upon determinable risk contingencies." Louisiana does not require a party to have an insurable interest in particular property to procure liability insurance for claims arising out of that property.[201] In the life settlement industry, individuals can purchase life insurance policies from insureds.[202] Even though the purchaser of the insurance policy does not have an insurable interest in the life of the person insured, the contract is still viewed as one of insurance (although the tax consequences for the beneficiary may change).[203]

The United States Supreme Court has developed a test to determine whether a practice is part of the "business of insurance" such that it falls within the purview of the McCarran-Ferguson Act and can be regulated by state insurance departments:

> [F]irst, whether the practice has the effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry.[204]

Noticeably absent from this test is whether the practice includes an insurable interest and provides for indemnity for actual loss. The Supreme Court has noted that the spreading and underwriting of risk are "indispensable characteristic[s] of insurance," and that the legislative history of the McCarran-Ferguson Act "strongly suggests that Congress understood the business of insurance to be the underwriting and spreading of risk."[205]

In cases brought by state insurance commissioners, federal courts have used this test to find that investment products (Retirement CDs) offered by banks were in fact the "business of insurance," such that the banks could not offer the products within states without first obtaining certificates of authority from the insurance

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requirement in the definition of "insurance" for regulatory purposes. *See, e.g.,* N.Y. Ins. Law § 1101(a)(1):

> "Insurance contract" means any agreement or other transaction whereby one party, the "insurer", is obligated to confer benefit of pecuniary value upon another party, the "insured" or "beneficiary", dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.

[201] *See* United Fire & Cas. Co. v. Reeder, 9 F.3d 15, 17 (5th Cir. 1993) (applying Louisiana law).

[202] *See* Ari J. Brandes, *A Better Way to Understand Credit Default Swaps*, 120 Tax Notes 235, 238 (July 21, 2008).

[203] *Id.*

[204] Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 129, 102 S. Ct. 3002, 3009, 73 L. Ed. 2d 647 (1982).

[205] Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 212, 221, 99 S. Ct. 1067, 1073, 1078, 59 L. Ed. 2d 261 (1979).

departments.[206] One may legitimately question whether this test is appropriate, in part because it was originally developed to determine whether practices engaged in by insurance companies were subject to federal laws and regulations,[207] but the point is that the test does not emphasize insurable interest or the principle of indemnity as necessary to the inquiry. Instead, the focus is on the risk shifting aspects of the practice in question.

Significantly, the NAIC also has viewed the shifting of risk as dispositive when analyzing whether to classify weather derivatives, hedges and swaps as insurance or capital markets products for purposes of state regulation.[208] In its Draft White Paper on the subject, the Property and Casualty Insurance Committee of the NAIC determined that weather derivatives and weather insurance exhibited the same four elements: (1) a contract where one party (2) promises to pay premiums to the other party in exchange for (3) the second party's promise to pay the first party in case of loss in case (4) a "contingent event" occurs.[209] The NAIC stated that "[t]he concept of risk is the central theme of the insurance contract."[210] Because weather derivatives and weather insurance both transfer risk and share other elements, the Draft White Paper recommended that weather derivatives be classified as insurance products for regulatory purposes.[211] The NAIC's analysis would seem to apply equally well to credit default swaps, notwithstanding any lack of insurable interest or indemnity for actual loss.[212]

Moreover, as discussed above, when the modern concept of insurance was first introduced there was no requirement that an insurance buyer have an insurable

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[206] *See* Blackfeet Nat'l Bank v. Nelson, 171 F.3d 1237, 1247–1248 (11th Cir. 1999); American Deposit Corp. v. Schacht, 84 F.3d 834, 842 (7th Cir. 1998). Of course, offering credit default swaps is not a practice that is limited to entities within the insurance industry, and so they do not meet the third prong of this test. However, the three factors are not essential elements that must be present and they "need not all point in the same direction." UNUM Life Ins. Co. of Am. v. Ward, 526 U.S. 358, 373, 119 S. Ct. 1380, 1389, 143 L. Ed. 2d 462 (1999).

[207] *See* Steven J. Williams, *Distinguishing "Insurance" from Investment Products Under the McCarran-Ferguson Act: Crafting a Rule of Decision*, 98 Colum. L. Rev. 1996 (Dec. 1998).

[208] Prop. and Cas. Ins. Comm., *Weather Financial Instruments (Temperature): Insurance or Capital Markets Products?* 3 (NAIC Draft White Paper Sept. 3, 2003) [hereinafter *Weather Financial Instruments*]. It should be noted that *Weather Financial Instruments* was never adopted as official policy by the NAIC.

[209] *Id.*

[210] *Id.* at 3–4, quoting Definition of Insurance Working Group, *Definition of Insurance Working Group White Paper* 4 (NAIC 2000).

[211] *Id.* at 8.

[212] The ISDA objected to the Draft White Paper on these very grounds. Letter from Robert G. Pickel, Executive Director and CEO, ISDA, to Ernst N. Csiszar, President, NAIC and Robert Esson, Senior Manager, Global Insurance Markets, NAIC (Feb. 23, 2004) (available at http://www.isda.org).

interest in the insured object or event.[213] The insurable interest requirement was imposed on insurance by legislatures and courts that were concerned over abuses of insurance caused by wagering on people's lives and livelihoods.[214] In other words, the insurable interest requirement itself is a form of regulation that is placed on insurance as a matter of public policy, not necessarily because it was originally seen as a fundamental element of the concept of insurance.

The principle of indemnity serves much the same function as the insurable interest requirement by reducing the "moral hazard" that might otherwise exist by discouraging due care to avoid a loss or even encouraging a loss to occur in order to gain a windfall.[215] As with insurable interest, not all types of insurance comport completely with the principle of indemnity. For example, a "valued property" insurance policy provides that in the event of a loss to property, the insurer will pay the amount stipulated in the policy as the value of the property, regardless of the property's "true" value as measured by other means.[216] "Replacement cost" coverage similarly provides for payment of the cost of replacing lost property, even though it results in the insured receiving a brand new building to replace an old, potentially worn down building.[217] A life insurance policy also does not strictly comply with the principle of indemnity by providing for fixed payments in the event of death without being overly concerned with the "true" value of the insured life.[218] As one treatise observes, there are many departures from strict indemnity that

> can be explained by other aspects of insurance or accommodations to the legal, political, and social system of which insurance is a part. Efficiency, equity, fairness, administrative convenience, marketing attractiveness, and even democratic sentiment are common themes that work to refine or alter the usual applicability of the indemnity principle for some cases or types of insurance.[219]

Given that the insurable interest and principle of indemnity were devised to counteract abuses of insurance, it hardly seems correct to say that a contract that violates these elements, and thus is potentially subject to the abuses they were designed to deter, should as a consequence *avoid* being subject to regulation. For example, many states' insurance codes have provisions that prevent an employer from being named as a beneficiary on its employees' life insurance policies unless

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[213] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11; Insurance Law, note 171 above, § 3.1, at 136.

[214] Holmes' Appleman on Insurance 2d, note 170 above, § 1.3, at 11–14; Insurance Law, note 171 above, § 3.1, at 136–138.

[215] Insurance Law, note 171 above, § 3.1, at 135; Principles of Insurance Law, note 173 above, § 1.03, at 55.

[216] Principles of Insurance Law, note 173 above, § 1.03, at 55.

[217] *Id.* § 1.03, at 56.

[218] *Id.* § 1.03, at 55.

[219] Stempel on Insurance Contracts, note 167 above, § 1.04.

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the employer would be financially affected by the employees' absence.[220] The reason is that the employer does not have an insurable interest in the employees' lives. The concern thus is over the employer simply betting on, and potentially profiting from, the life or death of the employees.[221] Viewed this way, concerns over whether an insured or beneficiary has an insurable interest in property or life arguably militate in favor of more or closer regulation, not less.

The primary purpose of credit default swaps now is for speculators to "place their bets" about the credit quality of a particular reference entity.[222] An investor with a negative view on the credit of a particular company's credit can buy a credit default swap that will pay if the company's credit goes bad.[223] The investor could, theoretically, attempt to affect the company's credit adversely by some means (*e.g.*, selling its stock short in the hopes of causing its value to drop severely) so as to collect on the swap. In other words, there potentially is a "moral hazard" associated with credit default swaps whose owners do not have an interest in the reference entity that should be mitigated as a matter of public policy.[224] Pushing the idea a bit further, one could view commercial banks as having succeeded in reinventing the insurance wagering contracts that were outlawed centuries ago. Pointing out the "moral hazard" of credit default swaps due to the lack of insurable interest and indemnity for actual loss would be an argument in favor of regulating them.

Notwithstanding the foregoing, state insurance commissioners may not be the best choice for regulating the complex world of credit default swaps. Courts, including the United States Supreme Court, have expressed concern over allowing state insurance departments to regulate financial instruments whose principal object is not providing insurance, because such instruments are "totally foreign to the business" of insurance that is the insurance departments' area of expertise.[225] In particular, credit default swaps are primarily vehicles for hedging credit risk, not for directly insuring against financial losses caused by covered events. The risk shifting aspects of credit default swaps are incidental to or an ancillary part

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[220] *See, e.g.,* Mich. Comp. Laws § 500.4404; 36 Okla. St. Ann. § 3604; Tex. Ins. Code Ann. § 1102.02; Mayo v. Hartford Life Ins. Co., 354 F.3d 400, 406–407 (5th Cir. 2004).

[221] *Mayo*, 354 F.3d at 406–07; Torrez v. Winn-Dixie Stores, Inc., 118 S.W.3d 817, 820 (Tex. App. Fort Worth 2003), *reh'g overruled* (2003).

[222] Pinsent, note 28 above.

[223] *Id.*

[224] *See Weather Financial Instruments*, note 208 above, at 8 (noting that energy traders could use weather derivatives to manipulate price of natural gas).

[225] SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 81, 79 S. Ct. 618, 627, 3 L. Ed. 2d 640 (1959) (Brennan, J., concurring) ("*VALIC*") (holding that company offering variable annuities must comply with securities law and was not offering "insurance" products). *See generally* Holmes' Appleman on Insurance 2d, note 170 above, § 1.4, at 31–37; Jordan v. Group Health Ass'n, 107 F.2d 239, 247–248 (D.C. Cir. 1939).

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of their principal object.[226] Consequently, credit default swaps shift risk in a way very different from traditional insurance. Instead of identifying classes of insureds with similar risk profiles and selling policies to these insureds based on similar premium rates, credit default swaps spread risk by being traded within a recognized market that matches counterparties with complementary and offsetting risk profiles.[227] State insurance departments have little experience or expertise in regulating trading markets like this, and it may not be wise for them to attempt to devise and enforce regulations in an area outside of their core competencies.

There also is the risk of overgeneralization and the slippery slope, because the arguments in favor of treating credit default swaps as insurance could be applied to many other types of derivatives, hedges and securitizations. As one commentator has observed, "[n]early any asset or derivative contract, *viewed from the perspective of either the long or short party*, can act as insurance."[228] Courts have been careful not to define insurance too broadly based on such concerns:

> [O]bviously it was not the purpose of the insurance statutes to regulate all arrangements for assumption or distribution of risk. That view would cause them to engulf practically all contracts, particularly contingent sales and contingent service agreements.[229]

Care should be taken to distinguish between contracts that offer "investment" risk — the possibility of gain or loss by entering into a transaction — and those that offer "insurance" risk — the possibility of loss if a covered event occurs.[230] Arguably, only the latter type of contract should be subject to insurance regulations to avoid the possibility that such regulations would "engulf" not only credit default swaps, but many, if not all, financial instruments that involve some measure of risk shifting.[231]

4. The Implications of Insurance Regulations on the Buying and Selling of Credit Default Swaps

If credit default swaps will be regulated as insurance products, the way that insurance is regulated could have profound effects on how credit default swaps are bought and sold. The primary purposes of regulation of insurance are the prevention of insolvency and the maintenance of the sound financial condition of

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[226] *Cf. VALIC*, 359 U.S. at 73 n.15, 79 S. Ct. at 623 n.15 (any shifting of risk in variable annuity contracts was "ancillary and secondary to the annuity feature" that did not make annuities insurance for purposes of federal regulation).

[227] *See* Schwartz, note 26 above, at 196–97.

[228] Brandes, note 202 above, at 239.

[229] *Jordan*, 107 F.2d at 248.

[230] *See* Helvering v. Le Geirse, 312 U.S. 531, 539–542, 61 S. Ct. 646, 649–650, 85 L. Ed. 996 (1941); Williams, note 207 above, at 2017–18.

[231] Williams, note 207 above, at 2018–19.

insurance companies.[232] State regulations accomplish these goals by requiring insurers to maintain sufficient cash reserves to pay all actual and anticipated claims.[233] Failure to maintain such reserves will result in an insurance company coming under scrutiny by the appropriate state insurance department, with possible rehabilitation, supervision and/or liquidation to protect the remaining assets of the insurer for the benefit of insureds.[234] State insurance regulations also curb other abuses by requiring that premium rates not be excessive, inadequate or unfairly discriminatory, that insurers comply with unfair trade practices and unfair claim settlement practices, and that claims are paid promptly.[235]

AIG's financial collapse was caused by its inability to provide sufficient collateral to meet the obligations of all the credit default swaps it had sold. In other words, AIG did not have enough cash on hand to pay all of the claims that were made or that could have been made under its credit default swaps. If AIG had been required to maintain sufficient cash reserves to cover its credit default swaps, its liquidity crisis could have been avoided.

At its height, the market for credit default swaps was valued at over $62 trillion.[236] Since this valuation was over twice the size of the total value of the United States stock markets, it is obvious that there was not enough cash available to pay out on the swaps. Thus, limiting the selling of credit default swaps to those for which adequate cash was on hand to pay potential claims would dramatically shrink the size of the market into something more manageable.

It is widely recognized that credit default swaps and other securitized instruments were not properly valued by the markets. The true value of the underlying securities (*e.g.*, mortgage-backed securities), and hence the true value of credit default swaps, is not yet known. Any attempt to require adequate cash reserves to back payments under credit default swaps would have to be based on fair and sound methods of valuing them, which may not exist yet. Until such valuation methods are devised, companies probably would be prohibited from selling credit default swaps under the relevant insurance regulations.

Because credit default swaps can be bought and sold multiple times, tracking down the company with the ultimate responsibility for paying a claim can be difficult. Short of limiting the ability to trade credit default swaps freely, which would greatly reduce their utility as risk hedging vehicles, greater transparency in trading to allow the payment obligations to be followed would be required.

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[232] *VALIC*, 359 U.S. at 90–91, 79 S. Ct. at 631–632, 3 L. Ed. 2d 640; *Blackfeet Nat'l Bank*, 171 F.3d at 1242.

[233] Insurance Law, note 171 above, § 8.2, at 938–941; Stempel on Insurance Contracts, note 167 above, § 2.04.

[234] Stempel on Insurance Contracts, note 167 above, § 2.04.

[235] Insurance Law, note 171 above, § 8.2, at 938–41; Stempel on Insurance Contracts, note 167 above, § 2.04.

[236] *See* Varchaver & Benner, note 23 above; Associated Press, note 23 above.

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Transparency also would ensure that the company with the ultimate payment responsibility has adequate cash reserves to pay claims.

Treating credit default swaps as insurance also could cause them to be guaranteed by at least some state insurance guaranty funds. The current size of the market clearly is too large to be remotely covered by state funds set aside for insurance insolvencies. On the other hand, reclassifying credit default swaps as insurance could create a new source of revenue for the states in the form of taxes on the premiums.[237]

Overall, these problems created by regulating credit default swaps as insurance could greatly reduce the market for trading them. They also could diminish the utility of credit default swaps as investment and risk hedging vehicles by limiting their ability to be traded freely and through taxes on the sale prices. State insurance departments may be loathe to begin the arduous and complicated task of writing appropriate regulations and reconfiguring their structures to allow them to regulate credit default swaps, which would require them to obtain some of the competencies of market regulators such as the Security and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). In short, there are powerful market and institutional forces which, as a practical matter, may make the regulation of credit default swaps as insurance difficult to achieve, regardless of the theoretical arguments for and against such regulation.

IV. CONCLUSION

AIG, along with Lehman Brothers, Citigroup, Washington Mutual, Wachovia, and other financial institutions, is a potent symbol of the perils of market deregulation. With the best of intentions, and not unreasonable economic theories, it was decided to leave the markets for credit default swaps and other derivatives unregulated. Perhaps the results should have been foreseen (bearing in mind Warren Buffett's description of credit default swaps as a "time bomb"), perhaps not. In any event, one of the largest insurance and financial services organizations in the world has been laid low. It would be remarkable if such an event did not have repercussions for the insurance industry. Although it is too early to tell whether AIG's insurance company subsidiaries will be materially affected, it also is too early for excessive optimism about their fate. AIG's fall has provided ammunition to critics of the current state-based system of insurance regulation and revealed how interconnected the worlds of finance, securities and insurance have become. In the modern financial services industry, a truly national voice of a federal regulator may be required as part of a comprehensive structure to regulate these worlds. Credit default swaps, half insurance and half something else, are reminiscent of a device from a much earlier time in the history of insurance, the wagering contract. One of the goals of any scheme to regulate credit default swaps, whether at the state or national level, should be to clarify the

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[237] *See Weather Financial Instruments*, note 208 above, at 8 (noting that classifying weather derivatives as insurance products would allow states to collect premium taxes when they are sold).

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status of these financial instruments so that appropriate regulations can be enacted.